



October 6, 1997

Promenade I  
1200 Peachtree St., N.E.  
Atlanta, GA 30309

Jim Llewellyn, Esquire  
BellSouth Corporation  
Campanile Building  
1155 Peachtree Street N.E.  
Atlanta, Georgia 30309

Via FAX

Dear Mr. Llewellyn:

In reference to Mike Tanner's phone call this afternoon, AT&T would like to view all documents that BellSouth contends are available for public inspection that are discussed in the Cochran affidavit. In particular, AT&T would like to see all documents discussed in paragraph 23 of the Cochran affidavit: "all transactions between BST and BSLD . . . have been reduced to writing and made available for public inspection." See also Cochran affidavit ¶ 19. Although AT&T believes that the documents discussed in paragraph 25, "all transactions involving joint marketing of services provided by BST to BSLD, or vice versa," are a subset of the documents referenced in paragraph 23, to the extent that BellSouth is referring to additional documents, AT&T also wishes to view these documents.

Please contact me if we will be unable to view these documents at 10 A.M. on October 7 at BellSouth Center, 675 West Peachtree Street, NE, Atlanta, Georgia, or if you have any additional questions.

Sincerely,

A handwritten signature in cursive script that reads "Patricia McFarland".

Patricia McFarland

# Attachment 3

# **REGIONAL AUDIT OF BELLSOUTH AND CERTAIN AFFILIATED COMPANIES**

**December 17, 1993**



**NATIONAL ASSOCIATION OF  
REGULATORY UTILITY COMMISSIONERS  
1102 Interstate Commerce Commission Building  
Constitution Avenue and Twelfth Street, NW  
Post Office Box 684  
Washington, DC 20044-0684  
Telephone No. (202) 898-2200  
Facsimile No. (202) 898-2213**

**Price: \$30.00**

there is a significant difference between discovery and auditing. The brief points out that the PSC internal procedures clearly distinguishes auditing from discovery and excludes auditors from the discovery process.

On July 19, 1993, Commissioner Clark held a "status" meeting in Docket No. 920160-TL. At this meeting all past due and incomplete responses to staff audit requests were addressed. New due dates were established. In response to a Company motion for more time to respond to audit requests, Commissioner Clark ruled that a fifteen day turnaround time is appropriate recognizing the complexity of this audit. The Commissioner made it clear that this was an audit not subject to discovery rules and the fifteen days was unique to this audit.

On August 27, 1993, Commissioner Clark held a second "status" meeting. At this meeting the Company represented that its affiliate, BellSouth Enterprises, to whom the Audit Team directed many requests, would comply to some of the audit requests but not under the timeframes established by Commissioner Clark. As a result, Commissioner Clark sent a letter to John Clendenin, CEO of BellSouth Corporation, requesting his assistance in getting BellSouth Enterprises to comply to audit requests on a timely basis. The Company responded by stating that "BellSouth Enterprises is committed to cooperation with the Florida Commission, within the law and the extent of its available resources, to provide timely and complete responses to requests that your audit team may make." Emphasis added. Obviously, the level of cooperation depends on the Company's interpretation of "within the law" and its designation of what resources will be available.

On October 4, 1993 the Florida Supreme Court heard arguments regarding access to affiliate records. As of this writing, a decision is pending.

On November 24, 1993 the Audit Team provided the Company a draft of the audit report and workpapers. The purpose was to give the Company time to verify the statements of facts in the report and designate claimed proprietary information in preparation for the exit conference scheduled for December 10, 1993. On December 8, 1993, the Company informed the Audit Team it will not attend the exit conference and plans on responding to the audit by way of rebuttal testimony and a "parallel" audit conducted by Deloitte and Touche CPA firm.

In summary, the Audit Team attempted to evaluate whether cross subsidy exists between BSTI's regulated and non regulated operations which is a national concern as evidenced by the previously mentioned NARUC resolution. Because of limited resources, the staff through analytical review limited its audit program to a relatively small number of affiliates and transactions. The Company displayed a consistent pattern of obstructionist behavior since May of 1992. Since an open and cooperative environment is essential for effective auditing, many of the audit objectives were not fulfilled. The proliferation of diversification activities by not only BellSouth but other telephone and electric companies has complicated the regulatory process. It will require regulation beyond the utility. The extent of that regulation needs to be defined.

# Attachment 4

Before the  
Federal Communications Commission  
Washington, D.C. 20554

In the Matter of

The BellSouth Telephone  
Operating Companies

AAD 93-148

**ORDER TO SHOW CAUSE**

Adopted: February 24, 1995;

Released: March 3, 1995

By the Commission:

1. At the direction of this Commission, the National Exchange Carriers' Association, Inc. ("NECA") hired Ernst and Young to conduct an independent audit of carrier-reported adjustments to the Common Line ("CL") revenue pool for 1988 and the first quarter of 1989.<sup>1</sup> Our subsequent review of that Commission-mandated audit revealed apparent violations of our accounting rules and reporting requirements by BellSouth Telephone Companies ("BellSouth") during the audit period. These apparent violations may have continued beyond the period covered by the audit. This Order to Show Cause sets forth those apparent violations and directs BellSouth to show cause why this Commission should not: (1) issue a Notice of Apparent Liability for Forfeiture ("NAL") for apparent violation of Section 220(d) of the Communications Act of 1934, as amended;<sup>2</sup> (2) require BellSouth to adjust its price cap indexes; and (3) require BellSouth to improve its internal processes to bring them into compliance with Commission rules and orders.

2. Enforcing our accounting rules and reporting requirements is essential for the Commission to carry out its statutory obligations to ensure that rates for telecommunications services remain just and reasonable. Our ability to

carry out these obligations is impaired if we cannot rely upon the information that carriers are required to submit about the costs of their operations and their allocations of those costs, or if those allocations are made improperly. As the telecommunications marketplace continues to diversify, with carriers providing more and more nonregulated services, our enforcement of accounting safeguards will become even more important if we are to continue to protect ratepayers from being overcharged for interstate services.

**I. BACKGROUND**

3. Our rules require the LECs, on a monthly basis, to report to NECA their revenue, expense and investment data. NECA uses these data to compute each LEC's monthly pool shares.<sup>3</sup> Because LECs do not have complete data available when they first report to NECA, the LECs initially report estimated data. In the following months, the LECs are required to reconcile their estimates with actual results. To ensure the accuracy of the reconciliation process and because even the best accounting systems sometimes fail to prevent errors, NECA procedures allow the LECs twenty-four months to reconcile and correct previously submitted data. Thus, in each monthly "settlement cycle," LECs report estimated data for the current month as well as adjusted data for the preceding twenty-four months.

4. In the December 1988 settlement cycle, certain LECs reported unusually large adjustments to the CL pool. Commission staff audited the larger of these adjustments and found that they appeared to have been encouraged by NECA Board members representing the BOCs and further found them apparently inconsistent with the Commission's rules. As a result, the Commission issued *Notices of Apparent Liability for Forfeiture and Orders to Show Cause* against the BOCs that filed these adjustments.<sup>4</sup> The Commission also issued a letter of reprimand to the NECA Board of Directors and required, *inter alia*, that NECA hire an independent auditor to perform a comprehensive audit of significant adjustments the BOCs reported to the CL pool for 1988 and 1989.<sup>5</sup>

<sup>1</sup> NECA collects cost data, including revenue, expense and investment data, from all local exchange carriers ("LECs") on a monthly basis. These data are then used to develop LEC-specific revenue requirements which are designed to recover those LEC-incurred costs that are allocated to the interstate jurisdiction under our jurisdictional separations rules, 47 C.F.R. Part 36. The revenue requirement development process is called "pooling," because, initially, all LEC-submitted cost data are combined ("pooled") based on whether they are non-traffic sensitive (e.g., CL) or traffic sensitive ("TS") in nature. Accordingly, NECA administers two revenue pools. Non-traffic sensitive, CL costs are pooled to develop CL revenue requirements, and TS costs are pooled to develop TS revenue requirements. The revenues required to recover CL costs are collected through (1) carrier common line charges billed to the interexchange carriers; (2) subscriber line charges billed to end users and other customers; and (3) surcharges assessed against special access customers. These charges are set forth in tariffs NECA prepares for pool members, primarily the smaller, independent LECs. Other LECs -- including the Bell Operating Companies ("BOCs") -- currently do not participate in the cost recovery pools and, instead, prepare their own access tariffs. As explained *infra*, however, the pools are calculated based on revenue data provided by all LECs, and revenue data reported to NECA by

the large carriers will, therefore, affect the charges of pool members. Moreover, during the time period covered by the audit, our rules required all LECs to participate in the CL pool.

<sup>2</sup> 47 U.S.C. §220(d). The BellSouth operating companies are the South Central Bell Telephone Co. (SCB) and the Southern Bell Telephone and Telegraph Co. (SBT).

<sup>3</sup> 47 C.F.R. §69.605.

<sup>4</sup> See, e.g., *Southwestern Bell Telephone Co., Notice of Apparent Liability for Forfeiture and Order to Show Cause*, 5 FCC Rcd 7179 (1990). The Commission subsequently entered into Consent Decrees with the carriers thus resolving these initial actions without determinations of liability. See, e.g., *Southwestern Bell Telephone Co., Consent Decree Order*, 7 FCC Rcd 7692 (1992).

<sup>5</sup> Letter from Donna R. Searcy, Secretary, FCC, to Lawrence C. Ware, Chairman of the Board of Directors, NECA, 5 FCC Rcd 7183 (1990). The letter identified "significant adjustments" as individual adjustments of \$100,000 or more that the BOCs had reported to the CL pool for 1988 and 1989 other than the adjustments that had been addressed in the Commission audit. The independent audit covered the fifteen data months from January 1, 1988 through March 31, 1989, after which time participation in the CL pool became voluntary and all BOCs left that pool. The letter, however, also required that the in-

5. NECA hired the public accounting firm of Ernst & Young to conduct the independent audit. Ernst & Young issued its report which NECA submitted to the Commission.<sup>6</sup> That report included numerous audit findings against the BOCs, including BellSouth; the conduct noted by Ernst & Young has a substantial impact on the CL pool as well as on the carriers' interstate telecommunications services customers. This is because NECA distributes access (tariff revenue based on reported data. Moreover, since the reported adjustments to the CL pool involve misstatements or miscalculations of interstate costs and revenues historically used to develop the reporting carrier's access charges, and, after 1988, its price cap indexes, the reporting carrier's interstate access customers, as well as end users, are affected. Although the independent auditor's report addressed the effects of the BOCs' conduct only on the CL pool, Commission auditors are examining the effect on all interstate telecommunications services. Those of the independent auditor's findings that were directed against BellSouth and that warrant Commission action are the subject of our action here. These findings are summarized below. Attachment A provides the specific details of each finding, the Commission Rules that were apparently violated, and the companies' responses to those findings. Attachment B presents, in tabular form, a summary of the apparent violations and their revenue impacts as revealed by the record to date.

## II. THE FINDINGS

6. Section 220(a) of the Communications Act grants to the Commission specific authority to "prescribe the forms of any and all accounts, records, and memoranda to be kept by carriers subject [to the Act]...."<sup>7</sup> In turn, Section 220(d) authorizes the Commission to impose forfeitures on carriers who do not keep such accounts, records, and memoranda in the manner prescribed by the Commission. The findings in Attachment A appear to reveal conduct by the BellSouth carriers that violates Section 220 for the period that is the subject of the audit, namely, the period beginning January 1, 1988, and ending March 31, 1989.<sup>8</sup>

dependent audit "include adjustments reported after [the BOCs] left the pool on April 1, 1989" since carriers were allowed to submit adjustments for up to twenty-four months following a particular data month. *Id.* As a result, the independent auditor examined reported CL pool adjustments through March 1991.

<sup>6</sup> The Ernst & Young audit report is hereafter referred to as the "Adjustments Report." On February 11, 1993, the Commission concluded that this audit had complied with Commission directives and had been performed "with a high degree of skill and care," and that the independent auditor had "exercised sound professional judgment reflecting purposes of the [audit] and the information gathered during [its] course." See Letter from Donna R. Searcy, Secretary, FCC, to Robert A. McArthur, Chairman of the Board of Directors, NECA, 8 FCC Red 1315 (1993).

<sup>7</sup> 47 U.S.C. §220(a).

<sup>8</sup> The apparent violations roughly fall into two categories for purposes of potential remedies. First, certain apparent violations found to fall outside the applicable limitations period for assessing forfeitures may, nevertheless, necessitate corrective action by the Commission. For example, the Commission may require adjustments to carrier price cap indexes to eliminate distortions caused by unlawful conduct. Second, other apparent violations, if found to be continuing or to have continued into the period covered by the limitations period, could support Notices of

7. The independent auditor's findings that we address here involve the misstatement or miscalculation of some \$6.2 million of interstate costs and revenues for the period from January 1988 through March 1989.<sup>9</sup> In the aggregate, these misstatements or miscalculations apparently benefited BellSouth to the detriment of the users of BellSouth's interstate services. FNN These misstatements or miscalculations shifted costs between or among access elements, thus apparently understating or overstating BellSouth's interstate revenue requirements for particular services. The seriousness of the misstatements is compounded here not only because of the net impact and the extent of understatements and overstatements, but also because of the scope and number of the errors or apparent violations and the fact that some of them may have continued to the date of this Order to Show Cause. The findings reveal the BellSouth carriers' apparent failure to maintain their accounts, records, and memoranda in the manner prescribed by the Commission. To the extent that this conduct has continued, it must seriously undermine the Commission's confidence that BellSouth's accounts accurately reflect Commission-mandated accounting practices and reveal the true and lawful costs of BellSouth's interstate services. Moreover, and as explained more fully below, the apparent rule violations and misstatements may very well have led BellSouth to compute price cap indexes that likely would require correction.

8. In the following paragraphs we describe the accounting irregularities that have led us to issue this Order to Show Cause.

### A. Apparent Cash Working Capital Violations

9. The independent auditor found that BellSouth's calculation of cash working capital allowances apparently violated Commission rules.<sup>10</sup> These allowances are supposed to reflect the average amount of investor-supplied capital needed to fund carriers' day-to-day operations.<sup>11</sup> Each cash working capital allowance is added to a carrier's ratebase, thereby increasing the earnings the carrier is allowed. The BellSouth carriers calculate their cash working capital allowances based on lead-lag studies.<sup>12</sup> In computing cash

Apparent Liability for Forfeiture under Section 1.800 of the Commission's Rules, 47 C.F.R. §1.800, as well as support other remedies, such as price cap adjustments.

<sup>9</sup> These figures are based on estimates BellSouth provided to the independent auditor. See Letter from Bruce Baldwin, President, National Exchange Carrier Association, Inc., to Mr. Gerald P. Vaughan, Deputy Chief, Operations, Common Carrier Bureau, at BellSouth Attachment (Oct. 12, 1992). Although those estimates encompass most of the independent auditor's findings, BellSouth did not provide interstate impact estimates of the impact of certain findings on interstate rates and revenue requirements.

<sup>10</sup> Attachment A, at 1.

<sup>11</sup> See Attachment A, at 3 n 17.

<sup>12</sup> See Attachment A, at 1-2. Lead-lag studies measure cash inflows and outflows in relation to the time service is rendered. Revenue and expense items that are received or paid before a service is rendered are considered "lead" items, and revenue and expense items that are received or paid after service is rendered are considered "lag" items. Lead-lag studies determine the number of days between receipt of revenues and payment of expenses.

working capital allowances, carriers are allowed to add minimum bank balances required by banks to the results obtained from these lead-lag studies. The independent auditor found that BellSouth improperly used average daily ledger balances, rather than minimum bank balances, which resulted in an overstatement of its total interstate revenue requirement of \$4.8 million.<sup>13</sup>

#### B. Apparent Jurisdictional Separations Violations

10. Responsibility for regulating telephone services is shared between this Commission, which regulates interstate service, and state commissions, which regulate intrastate service. Carriers must use a process called jurisdictional separations to apportion their costs and revenues between the state and interstate jurisdictions. The separations procedures are set forth in Part 36 of our rules.<sup>14</sup> The independent auditor found that BellSouth apparently violated our rules in separating its investment in information origination/termination equipment and cable and wire facilities. According to the record,<sup>15</sup> these violations may have continued beyond the audit period.

#### C. Other Apparent Errors

11. The independent auditor also found a number of other apparent rule violations, including BellSouth's failure to provide adequate documentation to support numerous revenue and cost adjustments,<sup>16</sup> and its improper inclusion of presubscription revenues<sup>17</sup> for the predesignation of interexchange carriers<sup>18</sup> in Account 5081, Enduser revenue.<sup>19</sup> The independent auditor also noted that a BellSouth operating company incorrectly reported an accrual adjustment to NECA resulting in an overstatement of CL revenues which would apparently violate Section 69.605 of our rules.<sup>20</sup> As such errors and other violations accumulate, the data carriers report to NECA under Section 69.605 of our rules<sup>21</sup> and to us under Parts 43 and 65 of our rules<sup>22</sup> become increasingly unreliable. Although these errors may have no current impact on BellSouth's interstate rates, their number and scope persuade us to order BellSouth to show cause why its internal accounting and accounting-related processes should not generally be brought into compliance with Commission rules and orders.

### III. DISCUSSION AND CONCLUSION

#### A. NALs

12. We find that the BellSouth carriers' conduct appears to be inconsistent with their statutory obligation to maintain their accounts, records, and memoranda as prescribed by the Commission. Carriers must accumulate, process, and report their financial and operating data in accordance with very specific Commission requirements because we rely on those data to help us ensure that interstate telephone rates are just and reasonable. Moreover, we cannot evaluate how well our accounting rules work if carriers disregard or misinterpret these rules. Therefore, where, as appears to be the case with BellSouth, carriers either intentionally violate our rules or fail to maintain the internal systems necessary to ensure compliance with those rules, we believe forfeitures may be appropriate under Section 220 of the Act.<sup>23</sup>

13. Section 220(d) of the Act authorizes us to impose forfeitures of up to \$6000 per carrier per day for accounting-related violations.<sup>24</sup> Obviously, any violations that continued throughout the audit period and to the present could trigger substantial sums for the two BellSouth companies based on appropriate application of the statute of limitations. In order to make a determination about the amount of any forfeitures that may lie, we direct BellSouth to state when the conduct described in paragraphs 8 through 10 and detailed in Attachment A ceased, if ever, and otherwise show cause why notices of apparent liability pursuant to section 1.80 of the Commission's rules should not issue.<sup>25</sup> BellSouth's response should include a discussion of the appropriate application of the prescribed limitations period.<sup>26</sup> BellSouth's response also should identify any mitigating circumstances we should consider in determining forfeiture amounts.<sup>27</sup>

#### B. Adjustments to Price Cap Indexes

14. As indicated above, BellSouth did not provide estimates of the impact on interstate services rates and revenue requirements of certain conduct described in the independent auditor's findings.<sup>28</sup> So that we may assess the full impact of BellSouth's conduct, we order the BellSouth carriers to estimate the interstate impact of each of these findings, and to file those estimates with the Commission. This filing shall include estimates of the effect of each of the additional findings on BellSouth's CL, TS, special access, billing and collection, and interexchange costs and

<sup>13</sup> Attachment A, at 2.

<sup>14</sup> 47 C.F.R. Part 36.

<sup>15</sup> Attachment A, at 4-5.

<sup>16</sup> *Id.*, at 8-9.

<sup>17</sup> Presubscription revenues refer to the charges that LECs assess when an end user decides to change his or her primary interexchange carrier.

<sup>18</sup> Under our rules, an end user has the right to select one interexchange carrier as his or her primary carrier. See *Investigation of Access and Divestiture Related Tariffs*, 101 FCC 2d 911 (1985) (describing the presubscription process LECs must follow).

<sup>19</sup> Attachment A, at 9-10. Section 32.5081 of our rules, 47 C.F.R. § 32.5081, states that the end user revenue account (Account 5081) shall contain the federally tariffed monthly flat rate charge end users must pay. The independent auditor found

that BellSouth improperly included presubscription revenues, from its customers' predesignation of their primary interexchange carriers, in Account 5081.

<sup>20</sup> *Id.* at 9.

<sup>21</sup> 47 C.F.R. §69.605.

<sup>22</sup> 47 C.F.R. Parts 43, 65.

<sup>23</sup> Section 220(d) provides for forfeitures if a carrier fails to keep its accounts, records and memoranda in the manner prescribed by the Commission. 47 U.S.C. §220(d).

<sup>24</sup> 47 U.S.C. §220(d). Prior to December 19, 1989, the forfeiture amount was fixed at \$500 per violation per day.

<sup>25</sup> 47 C.F.R. §1.80.

<sup>26</sup> Although BellSouth's violations began January 1, 1988, we would assess forfeitures only for the period allowed for by limitations period. See 47 C.F.R. §1.80(c)(2).

<sup>27</sup> See 47 U.S.C. §504(b).

<sup>28</sup> See *supra* note 9. These findings are discussed in paragraphs 19 through 21 of Attachment A.



revenues for the period January 1, 1988 to the public release date of this Order to Show Cause. We also direct BellSouth to provide estimates of the impact on the operating companies' interstate revenue requirements attributable to all conduct discussed in this order and in Attachment A that continued beyond the period of the audit, and to file these estimates with its response.

15. Since January 1, 1991, the Commission has regulated BellSouth's interstate access charges using the LEC price caprules.<sup>29</sup> Under these rules, BellSouth's initial price cap indexes were established based upon its projected interstate access revenue requirements for the period July 1, 1990 to June 30, 1991. BellSouth's calculation of those revenue requirements may have reflected the practices detailed in Attachment A. Because, under price cap regulation, each succeeding price cap index for a basket of services is a function of an initial price cap index for that basket, BellSouth's price cap indexes for its interstate services (and, by definition, its interstate rates) would have continued to reflect the impact of any improper practices.<sup>30</sup> Absent Commission action, BellSouth's future indexes would reflect any overstatement as well. Therefore, we order BellSouth to show cause why we should not require it to reduce its current price cap indexes to remove any overstatement.<sup>31</sup>

#### C. Corrective Action

16. Finally, we tentatively conclude that we should direct the BellSouth carriers to improve their internal processes to bring them into compliance with Commission rules and orders, and we order those carriers to show cause why such action should not be required. We will take any additional actions we believe appropriate, including issuing a further Order to Show Cause, based on BellSouth's response.

#### IV. ORDERING CLAUSES

17. Accordingly, IT IS ORDERED, pursuant to Sections 4(i), 4(j), 220(d), and 504(b) of the Communications Act of 1934, as amended, 47 U.S.C. §§154(i), 154(j), 220(d), & 503(b), and Section 1.701 of the Commission's rules, 47 C.F.R. §1.701, that the BellSouth Telephone Operating Companies SHALL SHOW CAUSE within sixty (60) days of the release date of this Order to Show Cause why the Commission should not issue Notices of Apparent Liability for Forfeiture against these companies for failure to keep their accounts, records, and memoranda on the books and in the manner prescribed by the Commission as set out in this Order to Show Cause, including Attachments A and B which are hereby incorporated by reference, and therewith SHALL FILE any and all data and other information required by this Order to Show Cause, including information requested in Attachment A.

<sup>29</sup> See *Policies and Rules Concerning Rates for Dominant Carriers*, CC Docket No. 87-313, 5 FCC Rcd 6786 (1990) (*LEC Price Cap Order*), *Erratum*, 5 FCC Rcd 7664 (Com. Car. Bur. 1990), *modified on recon.*, 6 FCC Rcd 2637 (1991) (*LEC Reconsideration Order*), *aff'd*, *National Rural Telecom Ass'n v. FCC*, 988 F.2d 174 (D.C. Cir. 1993).

<sup>30</sup> See 47 C.F.R. §§61.44(b), 61.45(b)-(c).

<sup>31</sup> To achieve this, BellSouth would need to reduce its price cap indexes by the percentage change in its July 1, 1990 to June

18. IT IS FURTHER ORDERED, pursuant to Sections 4(i), 4(j), 201-203, 205, 215, 217-219, and 220 of the Communications Act of 1934, as amended, 47 U.S.C. §§154(i), 154(j), 201-03, 205, 215, 217-19, & 220, and Section 1.701 of the Commission's rules, 47 C.F.R. §1.701, that the BellSouth Telephone Operating Companies SHALL FILE within sixty (60) days of the release date of this Order to Show Cause interstate cost and revenue impact estimates as specified in paragraph 13, *supra*.

19. IT IS FURTHER ORDERED, pursuant to Sections 4(i), 4(j), 201-203, 205, 215, 217-219, and 220 of the Communications Act of 1934, as amended, 47 U.S.C. §§154(i), 154(j), 201-03, 205, 215, 217-19, & 220, and Section 1.701 of the Commission's rules, 47 C.F.R. §1.701, that the BellSouth Telephone Operating Companies SHALL SHOW CAUSE within sixty (60) days of the release date of this Order to Show Cause why they should not be required to adjust their price cap indexes as specified in paragraph 14, *supra*.

20. IT IS FURTHER ORDERED, pursuant to Sections 4(i), 4(j), 201-203, 205, 215, 217-219, and 220 of the Communications Act of 1934, as amended, 47 U.S.C. §§154(i), 154(j), 201-03, 205, 215, 217-19, and 220, and Section 1.701 of the Commission's rules, 47 C.F.R. §1.701, that the BellSouth Telephone Operating Companies SHALL SHOW CAUSE within sixty (60) days of the release date of this Order to Show Cause why they should not be required to improve their internal processes to bring them into compliance with Commission rules and orders.

21. IT IS FURTHER ORDERED that the Secretary shall send by certified mail a copy of this Order to Show Cause to BellSouth Telecommunications, Inc., 675 West Peachtree Street, N.E., Atlanta, Georgia 30375.

FEDERAL COMMUNICATIONS COMMISSION

William F. Caton  
Acting Secretary

#### Attachment A

1. We present below the apparent violations of the BellSouth carriers based on the findings in the Ernst & Young report that prompt us to issue the accompanying *Order to Show Cause*. For each apparent violation, we summarize the independent auditor's finding and any BellSouth reply. We also present our preliminary evaluation of the record. In general, the violations are categorized according to the ratemaking component affected. This attachment separates the apparent violations into the following categories: cash working capital, jurisdictional

30. 1991 projected interstate access revenue requirement that results from the removal of any overstatement. These reductions to the price cap indexes would need to be apportioned among the baskets based on the relative July 1, 1990 to June 30, 1991 projected interstate access revenue requirements in each basket.

separations, lack of documentation, and other apparent errors. In attachment B, we present the information in the record that describes the impact of these apparent violations on the BellSouth carriers' interstate revenue requirements for the fifteen-month audit period.

#### A. Cash Working Capital

2. We find that BellSouth's calculation of cash working capital allowances may have violated Commission requirements. Specifically, BellSouth's development of those allowances apparently violated Sections 65.800 and 65.820(d) and (e) of the Commission's rules, which instruct carriers on how to calculate the interstate rate base.<sup>1</sup> As a result of its cash working capital calculations, BellSouth reported incorrect information to NECA in apparent violation of Section 69.605 of the rules<sup>2</sup> and to the Commission in apparent violation of Section 65.600 of the rules.<sup>3</sup> Finally, to the extent this information has been reported in the Commission's automated database, Automated Reporting Management Information System (ARMIS), BellSouth also appears to have violated Section 43.21 of the rules, which requires that data filed in ARMIS be accurate, complete, and responsive, and certified as such by a senior carrier officer.<sup>4</sup>

3. The elements of lead-lag studies to calculate cash working capital were set forth in Docket No. 19129<sup>5</sup> and reaffirmed in Docket No. 86-497.<sup>6</sup> Lead-lag studies measure cash inflows and outflows in relation to the time service is rendered. Revenue and expense items that are received or paid before a service is rendered are considered "lead" items, and revenue and expense items that are received or paid after service is rendered are considered "lag" items.<sup>7</sup> Lead-lag studies determine the number of days between receipt of revenues and payment of expenses. The net number of revenue lag days is then multiplied by the average daily cash expenses to determine cash working capital.<sup>8</sup> A positive net lag results in a positive cash working capital allowance, which increases the rate base; a negative one results in a negative allowance, which reduces the rate base.<sup>9</sup> In previous orders and proceedings, we have set forth the specific criteria for the inclusion and exclu-

sion of various items in cash working capital calculations, but the general rule is that the net lead or lag is applied to the average daily cash expenses. The specifics of BellSouth's apparent violation are discussed below.

4. *Apparent Violation No. 1:* In calculating cash working capital allowances, carriers are allowed to add minimum bank balances to the results obtained from lead-lag studies. The independent auditor found that BellSouth substituted average daily cash balances for minimum bank balances in its cash working capital computations.<sup>10</sup> This practice resulted in a \$4,836,000 overstatement of BellSouth's interstate revenue requirements for January 1988 through March 1989, according to the independent auditor.<sup>11</sup>

5. BellSouth argues that its use of average daily cash balances is proper. To support its position, BellSouth cites American Telephone and Telegraph Company (AT&T) and Bell Communication Research, Inc. (Bellcore)<sup>12</sup> company documents that instruct carriers to use average daily bank balances when computing cash working capital. BellSouth contends that these documents make clear that the Commission permits the use of average daily cash balances in computing cash working capital.<sup>13</sup>

6. Although BellSouth admits that the 86-497 *Reconsideration Order*<sup>14</sup> stated that the Commission did not intend to depart from the established policy of including minimum bank balances in cash working capital, BellSouth maintains that the Commission had previously permitted more than minimum bank balances to be included in cash working capital. In this regard, BellSouth points out that in Docket No. 19129, the Commission required AT&T to submit a program of cash management to "minimize cash requirements for the daily operation of the business."<sup>15</sup> BellSouth maintains that requirement described a program that was not strictly limited to compensatory or minimum bank balances. BellSouth also contends that it has consistently included average daily cash balances as the minimum cash balance in its cash working capital determination.

<sup>1</sup> 47 C.F.R. §§65.800, 65.820(d)-(e). These rules require carriers, like the BellSouth carriers, to calculate the cash working capital component of their interstate rate base either by performing a lead-lag study of interstate revenue and expense items or by applying a specified formula. BellSouth elected to perform lead-lag studies.

<sup>2</sup> 47 C.F.R. §69.605.

<sup>3</sup> 47 C.F.R. §65.600. In these rate of return reports to the Commission, BellSouth is required to "provide full and specific answers to all questions propounded and information requested...." 47 C.F.R. §65.600(b), (d)(1).

<sup>4</sup> 47 C.F.R. §43.21(a).

<sup>5</sup> American Telephone & Telegraph Co., Docket No. 19129, *Phase II Final Decision*, 64 FCC 2d 1, 72-73, para. 187 (1977) (19129 *Phase II Final Decision*), *aff'd* *Phase II Initial Decision*, 64 FCC 2d 131 (1976) (19129 *Phase II Initial Decision*).

<sup>6</sup> Amendment of Part 65 of the Commission's Rules to Prescribe Components of the Rate Base and Net Income of Dominant Carriers, CC Docket No. 86-497, *Report and Order*, 3 FCC Rcd 269 (1987) (86-497 *Order*), *recon.*, 4 FCC Rcd 1697 (1989) (86-497 *Reconsideration Order*), *remanded sub nom. Illinois Bell Telephone Co. v. FCC*, 911 F.2d 776 (D.C. Cir. 1990) (*Illinois Bell I*), *on remand*, 7 FCC Rcd 296 (1991) (84-497 *Decision on Remand*), *affirmed sub nom. Illinois Bell Telephone Co. v. FCC*, 988 F.2d 1254 (D.C. Cir. 1993) (*Illinois Bell II*).

<sup>7</sup> Related terms include "expense lag" (the average net lag of all of a carrier's cash expenses); "revenue lag" (the average net lag of a carrier's revenues); and "net lag" (the net of a carrier's expense lag and revenue lag).

<sup>8</sup> 86-497 *Decision on Remand*, 7 FCC Rcd at 297, para. 9.

<sup>9</sup> Annual 1990 Access Tariff Filings, *Memorandum Opinion and Order*, 5 FCC Rcd 4177, 4219 (1990).

<sup>10</sup> *Adjustments Report* at 41.

<sup>11</sup> Letter from Bruce Baldwin, President, National Exchange Carrier Association, Inc., to Mr. Gerald P. Vaughan, Deputy Chief, Operations, Common Carrier Bureau, at BellSouth Attachment (October 12, 1992) (*October 12 Letter*).

<sup>12</sup> Bellcore is a corporation that was created at the 1984 divestiture of AT&T to provide research, engineering, and technical support services to its owners, the Regional Bell Holding Companies, and their affiliates, the Bell Operating Companies.

<sup>13</sup> *Adjustments Report* at 42-43, citing Comptrollers Letter M-318, Outline of Procedures for Preparing Cash Working Capital Lag Studies (AT&T Sept. 2, 1977); Section DR90.25 (AT&T Jan. 1983); Section SS10.30 (Bellcore June 1984); & Section 550, Issue 2 (Bellcore Sept. 1988).

<sup>14</sup> 4 FCC Rcd at 1699, para. 22.

<sup>15</sup> *Adjustments Report* at 44, quoting, *Phase II Final Decision*, 64 FCC 2d at 76, para. 195 & *Phase II Initial Decision*, 64 FCC 2d at 410, para. 908.

BellSouth states that the Commission has approved this practice in every AT&T rate filing since 1978 and every BellSouth rate filing since 1984.<sup>16</sup>

7. We do not find BellSouth's arguments persuasive because the Commission has long held that only minimum bank balances, and not average daily bank balances, should be included in the cash working capital computation. Company documents that interpret Commission policy or rules do not substitute for Commission policy or rules. Additionally, the Commission's request in Docket 19129 for information regarding AT&T's cash management practices cannot reasonably be interpreted to mean that average daily bank balances were to be included in cash working capital. That request was initiated by the Administrative Law Judge (ALJ), who made clear that minimum bank balances, rather than actual cash balances, were to be included in cash working capital.<sup>17</sup> In requiring AT&T to submit a cash management program, the ALJ noted that AT&T had "presented no evidence on the basis of which the Commission can rely to persuade [it] that the cash balances [AT&T] claims in its rate base are required in the rendition of service."<sup>18</sup> Indeed, in affirming the ALJ's requirement, the Commission specifically excluded "General Department demand deposits and petty cash working funds" from cash working capital.<sup>19</sup>

8. Lastly, BellSouth cites no Commission order or other document approving the inclusion of average daily bank balances in cash working capital. If we allowed BellSouth's or AT&T's rates to take effect despite such inclusion, it was only because those carriers' rate filings did not disclose their specific practices. BellSouth's method of calculating its cash working capital allowances apparently violates our requirements.

#### B. Jurisdictional Separations

9. *Apparent Violation No. 2*: Effective January 1, 1988, the Commission adopted Section 36.142(a) of the rules,<sup>20</sup> which requires certain carriers, including the BellSouth carriers, to apportion all information origination/termination (IOT) equipment costs,<sup>21</sup> other than those for coinless pay telephone equipment and detariffed customer premises equipment, between the federal and state jurisdictions using the transitional subscriber plant factor.<sup>22</sup>

<sup>16</sup> *Adjustments Report* at 44.

<sup>17</sup> The ALJ emphasized that:

working capital is intended to provide only for the current day-to-day needs of the business and not for any of the capital requirement. Second, working capital is the amount of dollars that are necessary to meet current needs, not the amount of dollars that a public utility would like to have on hand or might actually have on hand.

*Docket 19129 Phase II Initial Decision*, 64 FCC 2d at 403, para. 481.

<sup>18</sup> *Id.* at 409, para. 907.

<sup>19</sup> *Docket 19129 Phase II Final Decision*, 64 FCC 2d at 76, n.101. The General Department of AT&T provided the BOCs with centralized staff services. *Docket 19129 Phase II Initial Decision*, 64 FCC 2d at 144, para. 30.

<sup>20</sup> 47 C.F.R. §36.142(a).

<sup>21</sup> IOT equipment consists of electronic devices and supporting equipment used to originate and terminate telecommunication messages at the end users' premises. See 47 C.F.R. Part 36 Appendix B includes station apparatus such as telephone and

Section 69.303(b) of the Commission's rules, in turn, requires LECs to apportion the interstate portion of that investment between the special access and CL elements "on the basis of the relative number of equivalent lines in use."<sup>23</sup>

10. The independent auditor found that BellSouth directly assigned IOT investment to special access in its 1988 annual access tariff filing. BellSouth argues that Western Union challenged this direct assignment in comments on that BellSouth filing, that BellSouth defended the direct assignment in its response to Western Union, and that the Commission allowed BellSouth special access rates to go into effect. The independent auditor then cited the findings in the Commission staff audit of the CL pool that had prompted the Commission to order an independent audit.<sup>24</sup> In its audit report issued in November 1990,<sup>25</sup> the Commission staff concluded that direct assignment of IOT investment is inconsistent with Commission rules.<sup>26</sup> Although the independent auditor indicated that this direct assignment understated BellSouth's CL and total interstate revenue requirements for 1988 by \$15.3 million,<sup>27</sup> we believe that it instead shifted IOT costs for 1988 from CL to interstate special access, as shown in Attachment B.

11. BellSouth argues that the independent auditor's statements confirm that its treatment of IOT costs was completely appropriate and the only proper course it could have taken. BellSouth states that its 1988 tariff filing clearly displayed BellSouth's direct assignment of IOT costs to special access, that the Commission was clearly aware of its action, and that the Commission allowed the special access rates as well as NECA's CL rates to become effective with the allocation of IOT costs to special access. BellSouth argues that had it changed its allocation of IOT costs during this period, changes in both CL and special access rates would have been required to avoid a revenue-cost mismatch. BellSouth states further that the Commission staff did not indicate that the direct assignment of IOT costs was incorrect until it issued its audit report of the CL pool in November 1990, some two years after the allocation in question was used to establish rates. BellSouth states that if the Commission believes that this November 1990 interpretation is applicable to BellSouth, then the Commis-

miscellaneous equipment, teletypewriter equipment, small private branch exchanges, and radio equipment (excluding mobile) installed for the end users' use. It also includes embedded customer premise wiring, large private branch exchanges, public telephone terminal equipment, and other terminal equipment. See 47 C.F.R. §36.141(a).

<sup>22</sup> The subscriber plant factor was formerly used to allocate to interstate operations certain investment in plant: subscriber lines, station equipment, and a portion of central office switching used for message telephone service. Each company's subscriber plant factor was frozen at its 1981 average level and then phased into a nationwide basic allocation factor of 25% over eight years beginning January 1, 1990. Thus, the subscriber plant factor became known as the "transitional subscriber plant factor" during the phase-in period. 47 C.F.R. §36.154(c) (f).

<sup>23</sup> 47 C.F.R. §69.303(b).

<sup>24</sup> See *Order to Show Cause*, *supra* at para. 3.

<sup>25</sup> Audit Report, Review of Adjustments to the NECA Common Line Pool (Audits Branch Oct. 26, 1990).

<sup>26</sup> *Adjustments Report* at 39.

<sup>27</sup> *October 12 Letter*, at BellSouth Attachment

sion must consider reopening the CL pool for 1988 to allow BellSouth to submit additional IOT expenses for recovery.<sup>28</sup>

12. BellSouth, in effect, presents two arguments to justify its direct assignment of IOT costs. First, BellSouth argues that the interpretation of the rules set forth in the Commission staff's November 1990 audit report is incorrect. Second, BellSouth maintains that even if correct, that interpretation should not be applied to BellSouth because the 1988 Access Tariff Order<sup>29</sup> had allowed BellSouth's 1988 special access rate to go into effect even though it reflected a direct assignment of IOT costs to special access. We address these arguments in turn.

13. BellSouth's argument that the interpretation in the Commission staff's November 1990 audit report is incorrect apparently reflects BellSouth's belief that Part 36, and in particular Section 36.1(c), of our rules permit the direct assignment of IOT costs to special access.<sup>30</sup> Our Part 36 rules, however, prescribe the procedures telecommunications companies must use in apportioning their costs and revenues between the state and interstate jurisdictions. Sections 36.1 and 36.2 outline the separations procedures and the principles that underlie them.<sup>31</sup> These sections state that jurisdictional separations are to be made using either direct assignment or a particular allocator.<sup>32</sup> These general statements do not grant carriers discretion, but only introduce the Part 36 rules that explain when and how direct assignment or an allocator is to be used. If the general introductory statements had been meant as dispositive, there would have been no need for specific language, in the rules that follow, to allow or encourage the use of direct assignment.<sup>33</sup> Sections 36.1(c) and 36.2(a)(1) do not create a general invitation to use direct assignment as the filing carrier chooses.

14. BellSouth also maintains that the Commission implicitly accepted direct assignment of IOT costs to special access in amending Part 69 in 1987 because the Commission intended Part 69 to conform with Part 36.<sup>34</sup> We find no support for this argument in the language of Part 69. On the contrary, Section 69.303(b) of the Commission's rules states unequivocally that LECs are to apportion "all" IOT investment other than that in public telephones and

appurtenances between the special access and CL elements "on the basis of the relative number of equivalent lines in use."<sup>35</sup> There is no language in Section 69.303 or in other portions of Part 69 that states or implies that direct assignment is an alternative to this allocation method.

15. As the independent auditor observed, BellSouth and NECA both directly assigned IOT costs to special access in their 1988 access tariff filings, and the Common Carrier Bureau (Bureau) allowed BellSouth's special access and NECA's CL rates to take effect without correcting these improper direct assignments.<sup>36</sup> In allowing those rates to take effect, however, the Bureau made no finding as to their underlying lawfulness.<sup>37</sup> In these circumstances, we reject BellSouth's apparent position that this Bureau action absolved BellSouth of its responsibility to report its IOT costs to NECA in accordance with Sections 36.142(a) and 69.303(b). BellSouth should have been aware both from the language of the rule and from communications with NECA<sup>38</sup> that its direct assignment of IOT was inconsistent with the Commission's rules. Nevertheless, BellSouth continued to assign its IOT costs directly to special access during 1988 and attempted no retroactive adjustment to correct that improper direct assignment. Those actions apparently violated Sections 36.142(a) and 69.303(b) of our rules.

16. *Apparent Violation No. 3:* Section 36.153 of the Commission's rules prescribes the methods for assigning cable and wire facilities (C&WF) costs to four specific separations categories.<sup>39</sup> The independent auditor found that in Alabama, Louisiana, and Mississippi, BellSouth used an incorrect basic study factor<sup>40</sup> that decreased the C&WF costs assigned to category 2, Gwideband and exchange trunk C&WF, for private local service. The independent auditor stated that this incorrect factor shifted costs to category 1, exchange line C&WF excluding wideband, for which the costs are directly assigned to the CL rate element.<sup>41</sup> The independent auditor stated further that this

<sup>28</sup> *Adjustments Report* at 39-40.

<sup>29</sup> Annual 1988 Access Tariff Filings, *Memorandum, Opinion and Order*, 3 FCC Rcd 1281, 1295 (Com. Car. Bur. 1987) (1988 Access Tariff Order).

<sup>30</sup> *Id.* at 39, citing BellSouth Reply in 1988 Access Tariff Proceeding.

<sup>31</sup> 47 C.F.R. §§36.1, 36.2.

<sup>32</sup> 47 C.F.R. §§36.1(c), 36.2(a)(1).

<sup>33</sup> Compare 47 C.F.R. §36.157(a)(1) (certain cable and wire facilities costs to be apportioned) with 47 C.F.R. §36.157(a)(2) (other cable and wire facilities costs to be directly assigned).

<sup>34</sup> *Adjustments Report* at 39, citing BellSouth Reply in 1988 Access Tariff Proceeding.

<sup>35</sup> 47 C.F.R. §69.303(b).

<sup>36</sup> See Annual 1988 Access Tariff Filings, *Memorandum Opinion and Order*, 3 FCC Rcd 1281, 1295, paras. 114 & 116 (Com. Car. Bur. 1987) (allowing BellSouth's 1988 special access tariff to take effect notwithstanding Western Union's argument regarding the over allocation of IOT investment to special access).

<sup>37</sup> See *id.* The Bureau did not explain why it allowed BellSouth's special access tariff to take effect, while suspending the special access tariffs of other carriers.

<sup>38</sup> In June 1988, NECA's Separations Advisory Group informed

BellSouth that the Commission staff had concluded that BellSouth's IOT methodology was unacceptable. Response of the NYNEX Telephone Companies, New England Telephone & Telegraph Co. & New York Telephone Co., Apparent Violations of the Commission's Rules, Affidavit of Alfred Boschulte at Attachment A (filed Dec. 10, 1990). While informal advice of Commission staff is not definitive, *Malkan FM Assoc. v. FCC*, 935 F.2d 1313, 1319 (D.C. Cir. 1991), this communication should have alerted BellSouth that the Bureau, by allowing its 1988 special access tariff to take effect, had not intended to approve BellSouth's IOT methodology.

<sup>39</sup> Section 36.152 of the Commission's rules, 47 C.F.R. §36.152, lists these categories.

<sup>40</sup> Basic study factors are ratios such as minute miles per message or book costs per mile of cable that are applied to monthly volume counts, quantity counts, investment, expenses, or other data to assign costs in the separations process. Some basic study factors are used to assign costs to separations categories; other basic study factors are used to apportion plant investment, expenses, and taxes between the state and interstate jurisdictions. To develop basic study factors, the LECs periodically perform studies in which they analyze costs and other data for a specific period of time.

<sup>41</sup> *Adjustments Report* at 46-47.

error overstated BellSouth's interstate revenue requirements for January 1988 through March 1989 by \$1,025,000.<sup>42</sup>

17. BellSouth admits that the basic study factor was wrong and explains that a worksheet error produced it.<sup>43</sup> We find that BellSouth's use of this incorrect basic study factor apparently violated Section 36.153.

#### C. Lack of Documentation and Other Apparent Errors

18. *Apparent Violation No. 4:* One element of a reliable accounting system is maintaining records that support accounting entries. Section 220(c) of the Communications Act recognizes this by authorizing the Commission to have access to and the right of inspection and examination of "all accounts, records, and memoranda, including all documents, papers, and correspondence . . . kept or required to be kept" by the BellSouth carriers.<sup>44</sup> Section 220(c) also places "[t]he burden of proof to justify every accounting entry questioned by the Commission . . . on the person making, authorizing, or requiring such entry . . ."<sup>45</sup> In addition, Section 32.12(b) of our rules requires the BellSouth carriers to keep their accounting records "with sufficient particularity to show fully the facts pertaining to all accounting entries" and to file "[t]he detail records in such manner as to be readily accessible for examination" by Commission representatives.<sup>46</sup>

19. The independent auditor found twenty-two instances where revenue, cost, basic study or tax adjustments, each involving in excess of \$100,000 in costs or revenues, were unsupported by adequate documentation: South Central Bell in Alabama could not provide adequate documentation to support three adjustments.

South Central Bell in Kentucky could not provide support documentation for one adjustment.

South Central Bell in Louisiana could not provide support documentation for two adjustments.

South Central Bell in Mississippi could not provide support documentation for two adjustments.

South Central Bell in Tennessee was unable to provide support documentation for two adjustments.

Southern Bell in Florida could not provide support documentation for two adjustments.

Southern Bell in Georgia could not provide support documentation for four adjustments.

Southern Bell in North Carolina could not provide support documentation for two adjustments.

Southern Bell in South Carolina could not provide support documentation for four adjustments.<sup>47</sup>

20. In all twenty-two cases, BellSouth admits that it could not locate the supporting documentation.<sup>48</sup> We tentatively find that BellSouth's admitted documentation failures would support a conclusion that BellSouth fails to keep its accounts, records, and memoranda as prescribed by the Commission.

21. *Apparent Violation No. 5:* The 800 Readyline service was an AT&T 800 service that terminated over the customer's local exchange service line rather than over a dedicated WATS-type line. The independent auditor found that in Alabama, when reporting an 800 Readyline accrual adjustment to NECA, BellSouth reported an increase in revenues instead of the decrease which actually occurred. The error resulted in BellSouth's overstating its CL revenues for September 1988 by \$338,000.<sup>49</sup> BellSouth admits this error and explains that an input of \$169,000 was inadvertently made with the wrong sign resulting in the \$338,000 overstatement of revenue.<sup>50</sup> We find that in this instance, BellSouth's internal accounting controls were apparently deficient.

22. *Apparent Violation No. 6:* The independent auditor found that South Central Bell included presubscription revenues for the predesignation of interexchange carriers (IXCs) by end users in Account 5081, End user revenue, in apparent violation of Section 32.5081 of the Commission's rules.<sup>51</sup> This overstated BellSouth's CL revenues and understated its traffic sensitive revenues for January 1988 through March 1989 by \$999,000.<sup>52</sup>

23. We quote Section 32.5081 in its entirety:

§32.5081 End user revenue. This account shall contain the federally tariffed monthly flat rate charge assessed upon end users.<sup>53</sup>

We find no support here for BellSouth's inclusion of these revenues in Account 5081, and its eventual assignment of these revenues to the CL pool. Under the Commission's rules, Account 5081 contains revenue generated by the federally tariffed flat monthly rate charge assessed upon end users. Account 5081 does not include additional amounts, like presubscription revenues, even though they are tariffed amounts charged to end users. Presubscription revenues pertain to the switched message toll service, and carriers must include them in Account 5082, Switched access revenue,<sup>54</sup> which is assigned to the traffic sensitive element as miscellaneous service revenues. Thus, apparently, BellSouth not only reported these revenues to the wrong NECA pool, but also recorded them in the wrong account.

24. The above errors suggest that BellSouth's internal controls apparently failed to function properly in multiple instances. As a result of such errors, it may be necessary to require adjustments to BellSouth's price cap indexes and

<sup>42</sup> October 12 Letter, at BellSouth Attachment.

<sup>43</sup> Adjustments Report at 47.

<sup>44</sup> 47 U.S.C. §220(c).

<sup>45</sup> Id.

<sup>46</sup> 47 C.F.R. §32.12(b).

<sup>47</sup> Adjustments Report at 45-46.

<sup>48</sup> Id. at 46.

<sup>49</sup> Adjustments Report at 47.

<sup>50</sup> Id.

<sup>51</sup> Id.

<sup>52</sup> October 12 Letter, at BellSouth Attachment.

<sup>53</sup> 47 C.F.R. §32.5081.

<sup>54</sup> 47 C.F.R. §32.5082.

take other remedial action depending upon our review of the additional information we have directed BellSouth to submit.

## Attachment B

## BELLSOUTH - Summary of Apparent Violations

INTERSTATE REVENUE REQUIREMENT  
OVERSTATEMENT FOR THE AUDIT PERIOD (See Note)  
(\$000)

COMMISSION FINDING	CARRIER	TOTAL	COMMON LINE	OTHER INTERSTATE ACCESS ELEMENTS
1. Included amounts in excess of minimum bank balances in computing CWC.	BellSouth	4,836	2,661	2,175
2. Used direct assignment of IO/T where not allowed.	BellSouth	0	(13,300)	13,300
3. Used incorrect basic study for C&WF Category 2.	BellSouth	1,025	854	171
4. Numerous unsupported retroactive adjustments.	BellSouth		Unknown	
5. Errors in reporting 800 readyline service revenues.	BellSouth	(338)	(338)	0
6. Erroneously reported PICC revenues to common line.	BellSouth	0	(999)	999

Note: Overstated expenses are indicated by positive amounts.  
Understated expenses are indicated by negative (parentheses) amounts.  
Overstated revenues are indicated by negative (parentheses) amounts.  
Understated revenues are indicated by positive amounts.

# Attachment 5



Before the  
Federal Communications Commission  
Washington, D.C. 20554

In the Matter of )  
 )  
The BellSouth Telephone ) AAD No. 93-148  
Operating Companies )  
 )

**CONSENT DECREE ORDER**

**Adopted: October 15, 1996**

**Released: November 1, 1996**

**By the Commission:**

1. At the direction of the Commission, the National Exchange Carrier Association, Inc. ("NECA") hired Ernst and Young to conduct an independent audit of carrier-reported adjustments to the common line revenue pool for 1988 and the first quarter of 1989. On December 9, 1991, NECA submitted to the Commission Ernst and Young's report ("Adjustments Report").<sup>1</sup>

2. The independent auditor reported numerous apparent violations of the Commission's rules committed by the Bell Operating Companies, including BellSouth Telecommunications, Inc. ("BellSouth").<sup>2</sup> These apparent violations generally involve failures to keep accounts, memoranda and records in the manner prescribed by the Commission.

3. On March 3, 1995, the Commission released an *Order to Show Cause*<sup>3</sup> directing BellSouth to show cause why the Commission should not: (1) issue a Notice of Apparent Liability for Forfeiture for apparent violation of Section 220(d) of the Communications Act of 1934, as amended;<sup>4</sup> (2) require BellSouth to adjust its price cap indexes; and (3) require BellSouth to improve its internal processes to bring them into compliance with Commission rules

<sup>1</sup> Letter to Robert A. McArton from Donna Searcy, 8 FCC Rcd 1315 (1993).

<sup>2</sup> On January 1, 1992, the former BellSouth operating companies, Southern Bell Telephone and Telegraph Co. and South Central Bell Telephone Co., were merged into BellSouth Telecommunications, Inc.

<sup>3</sup> BellSouth Telecommunications, Inc., *Order to Show Cause*, 10 FCC Rcd 5637 (1995) (*Order to Show Cause*).

<sup>4</sup> 47 U.S.C. § 220(d).

and orders.

4. On May 2, 1995, BellSouth responded to the Commission's *Order to Show Cause* and contested and denied each of the NECA audit report findings listed in the Commission's Order. By public notice dated June 20, 1995, the Common Carrier Bureau invited public comment on BellSouth's response.<sup>5</sup> Only MCI Telecommunications Corporation filed comments, and BellSouth replied on September 11, 1995.

5. This Commission and BellSouth have reached an agreement with respect to these audit findings. The terms and conditions of this agreement are contained in the attached Consent Decree.

6. We have reviewed the terms of the Consent Decree and evaluated the circumstances of the case. We believe the public interest would be served by approving the Consent Decree, the terms of which are incorporated herein by reference.

7. Accordingly, IT IS ORDERED, pursuant to Sections 4(i) and 4(j) of the Communications Act of 1934, as amended, 47 U.S.C. §§ 154(i) and (j), that the Consent Decree, incorporated by reference herein and attached to this Order, IS HEREBY ADOPTED, and the Secretary shall sign such Consent Decree on behalf of the Commission.

8. IT IS FURTHER ORDERED that this Order is effective upon execution of the Consent Decree by all parties to the Agreement.

9. IT IS FURTHER ORDERED that proceedings under the March 3, 1995 *Order to Show Cause*, 10 FCC Rcd 5637, ARE HEREBY TERMINATED.

FEDERAL COMMUNICATIONS COMMISSION

William F. Caton  
Acting Secretary

---

<sup>5</sup> Commission Sets Pleading Schedule In Show Cause Proceedings, *Public Notice*, 10 FCC Rcd 10939 (1995).

Before the  
Federal Communications Commission  
Washington, D.C. 20554

In the Matter of )  
 )  
The BellSouth Telephone ) AAD No. 93-148  
Operating Companies )  
 )

### CONSENT DECREE

1. This is a Consent Decree entered into by the Federal Communications Commission ("Commission") and BellSouth Telecommunications, Inc. ("BellSouth") (collectively referred to herein as the "Parties").<sup>1</sup>

2. The common line revenue pool is administered by the National Exchange Carrier Association, Inc. ("NECA") and allows incumbent local exchange carriers ("LECs") to participate in a tariff filed by NECA that establishes uniform access rates on a nation-wide basis for all participants. Monthly distributions from the pool are computed using monthly revenue, expense and investment figures reported by the participating LECs. Initially the figures are only estimates, but in later months the incumbent LECs adjust them to actual monthly figures. At the direction of the Commission, NECA hired Ernst and Young to conduct an independent audit of carrier-reported adjustments to the common line revenue pool for 1988 and the first quarter of 1989. The Ernst and Young audit report ("Adjustments Report") included numerous audit findings against the Bell Operating Companies, including BellSouth, concerning apparent rule violations and misconduct. These findings generally involve failures to keep accounts, memoranda and records in the manner prescribed by the Commission.

3. On March 3, 1995, the Commission released an *Order to Show Cause* directing BellSouth to respond to certain of the findings in the Adjustments Report.<sup>2</sup> On May 2, 1995, BellSouth responded to the Commission's *Order to Show Cause* and contested and denied each of the Adjustments Report findings listed in the Commission's Order. By public notice dated June 20, 1995, the Common Carrier Bureau invited public comment on

<sup>1</sup> On January 1, 1992, the former BellSouth operating companies, Southern Bell Telephone and Telegraph Co. and South Central Bell Telephone Co., were merged into BellSouth Telecommunications, Inc.

<sup>2</sup> BellSouth Telecommunications, Inc., *Order to Show Cause*, 10 FCC Rcd 5637 (1995) (*Order to Show Cause*).

BellSouth's response.<sup>3</sup> Only MCI Communications Corporation filed comments, and BellSouth replied on September 11, 1995. The positions of the parties to this consent decree are as follows:

- (a) The Commission found that BellSouth's actions appear to be inconsistent with its statutory obligation to maintain its accounts, records, and memoranda as prescribed by the Commission. Generally, the Commission found that BellSouth had apparently misstated or miscalculated interstate costs and revenues from January 1988 through March 1989. The Commission's specific findings included:
  - (i) The Commission found that BellSouth's calculation of Cash Working Capital apparently violated Commission rules, improperly using average daily cash balances instead of required minimum bank balances.
  - (ii) The Commission found apparent violations of its rules because BellSouth failed to separate correctly its investment in information origination/termination equipment costs in apparent violation of Part 36 of the Commission's rules.<sup>4</sup>
  - (iii) The Commission found a number of other apparent violations of its rules, including BellSouth's failure to provide adequate documentation to support numerous revenue and cost adjustments, and its improper inclusion of presubscription revenues for the predesignation of interexchange carriers in Account 5081, End user revenue. The independent auditor also noted that a BellSouth operating company incorrectly reported an accrual adjustment to NECA resulting in overstatement of common line revenues which would apparently violate Section 69.605 of our rules.<sup>5</sup>
- (b) BellSouth responded to the *Order to Show Cause* contesting liability on all counts, and asserting that no price cap index adjustment was

<sup>3</sup> Commission Sets Pleading Schedule In Show Cause Proceedings, *Public Notice*, 10 FCC Rcd 10939 (1995).

<sup>4</sup> 47 C.F.R. Part 36.

<sup>5</sup> 47 C.F.R. § 69.605.

appropriate or lawful.<sup>6</sup> BellSouth contests all findings in the Adjustments Report and the Commission's *Order to Show Cause*, on the following grounds:

- (i) Due to its efficient cash management practices, its average daily cash balance was, in fact, the minimum bank balance that BellSouth could maintain and still operate its business. BellSouth also contends that its average daily cash balance represented investor supplied funds that were used and useful in the operation of its business, and that BellSouth was legally entitled to include such amounts in its rate base. BellSouth also argues that it had followed a uniform practice of including its average daily cash balance in its rate base since 1977.<sup>7</sup>
- (ii) BellSouth used direct assignment in good faith and in reliance on the Commission's stated policy of favoring direct assignment whenever possible. BellSouth argues that the information origination/termination equipment in question was directly associated with the provision of special access service, and direct assignment represented a more cost-causative approach than allocation of a portion of these costs to common line.<sup>8</sup>
- (iii) During the transition from Part 67 to Part 36 separations rules, an input error occurred that affected the separations factors for cable and wire facilities in the states of Alabama, Louisiana and Mississippi. As a result, the interstate revenue requirement was overstated by approximately \$1 million and the intrastate revenue requirement was understated by the same amount. BellSouth contends that the impact of the error ceased with the introduction of a new basic factor for these three states on July 1, 1990 and that the error did not affect BellSouth's initial price cap indexes.<sup>9</sup>
- (iv) The independent auditor identified 22 instances in which it

---

<sup>6</sup> BellSouth Response to Order to Show Cause, filed herein May 2, 1995; BellSouth Reply Comments, filed herein September 11, 1995.

<sup>7</sup> BellSouth Response to Order to Show Cause, at 6-16.

<sup>8</sup> *Id.* at 16-26.

<sup>9</sup> *Id.* at 26-31.

concluded that BellSouth provided inadequate documentation and, based on this, the *Order to Show Cause* tentatively found that BellSouth failed to maintain adequate controls to comply with Part 32. BellSouth states that the independent auditor reviewed over 3,000 adjustments to the common line pool. BellSouth also states that there was no suggestion by the auditor that the entries in question were erroneous: these were documentation issues only and the items cited as documentation errors were extremely minor and in many cases BellSouth has no business reason to maintain formal documentation for the particular types of transactions in question.<sup>10</sup>

- (v) A human error occurred in which a \$169,000 accrual adjustment was reported with the wrong sign, resulting in BellSouth overstating common line revenue in September, 1988 by \$338,000. BellSouth therefore under-recovered from the common line pool in this amount. The *Order to Show Cause* cites this error as an example of allegedly deficient internal controls. BellSouth asserts that this was a case of simple human error that did not recur and had no impact on BellSouth's initial price cap indexes.
- (vi) BellSouth states that the rules for the treatment of presubscription revenues for the predesignation of interexchange carriers were never clear. While BellSouth now agrees to accept the interpretation of Ernst and Young that these revenues were more properly associated with switching and therefore should be excluded from common line pool reporting, BellSouth could find no authoritative interpretation from the period under review that specified the proper treatment of these revenues. BellSouth asserts that the rules were ambiguous and that BellSouth made a good faith interpretation of the rules to determine the proper treatment of these revenues. In any event, presubscription revenues are excluded from price caps.<sup>11</sup>

4. The Commission and BellSouth agree that the expeditious resolution of issues raised by the Adjustments Report and the Commission's *Order to Show Cause* in

---

<sup>10</sup> *Id.* at 31-39.

<sup>11</sup> *Id.*, at 43-47.

accordance with the terms of this Consent Decree is in the public interest.

5. Accordingly, and in consideration of the agreement of the Commission and BellSouth to conclude action on the *Order to Show Cause* on the terms set forth in this Consent Decree, BellSouth agrees to act as specified below:

- (a) BellSouth agrees to correct any past accounting and recordkeeping deficiencies that might have caused the apparent violations set forth in paragraph 3 of this Consent Decree;
- (b) BellSouth agrees to establish procedures to prevent the specific apparent deficiencies from recurring in the future;
- (c) BellSouth agrees not to include revenues from customers for the predesignation of their primary interexchange carrier in Account 5081, and shall instead include these revenues in Account 5082, in compliance with the Commission's rules;<sup>12</sup>
- (d) BellSouth agrees to conduct an independent audit of its internal accounting controls as specified in Attachment A of this Consent Decree;

6. In the event BellSouth fails to comply with the requirements set forth in paragraph 5 and Attachment A of this Consent Decree, the Commission reserves the right to pursue legal action against BellSouth. If BellSouth complies with the terms set forth in paragraph 5 and Attachment A of this Consent Decree, then the accounting treatments, procedures and documentation adopted in compliance with paragraph 5 and Attachment A shall be regarded by the Commission as presumptively reasonable and lawful. The Commission, however, reserves its rights under law to change accounting requirements prospectively and retroactively as long as no penalty attaches to such retroactive application. Likewise, BellSouth shall be authorized to make changes to its accounting treatments, procedures and documentation to implement or reflect changes in the law or rules or waivers of the Commission's rules, and shall not thereby be in violation of any part of this Consent Decree.

7. In light of BellSouth's covenants and representations contained in paragraph 5 and Attachment A of this Consent Decree, and in express reliance thereon, the Commission has issued a final order formally authorizing the Secretary to execute this Consent Decree ("Consent Decree Order") without change, addition or modification and

---

<sup>12</sup> See 47 C.F.R. §§ 32.5081 and 32.5082.

without a finding of wrongdoing, violations or liability by BellSouth and further agrees not to begin, on the motion of the Commission or its staff, any proceeding formal or informal, concerning matters that were the subject of the Adjustments Report. Nothing herein, however, shall preclude the Commission from using the information underlying the findings and observations in the Adjustments Report for other lawful regulatory purposes provided that BellSouth shall have all opportunities afforded by law to contest that use and that information.

8. BellSouth admits the jurisdiction of the Commission to adopt this Consent Decree.

9. BellSouth waives any rights it may have to judicial review, appeal or rights otherwise to challenge or contest the validity of the Consent Decree Order, provided the Commission adopts this Consent Decree without change, addition or modification.

10. The Parties agree not to engage in conduct inconsistent with the terms of this Consent Decree. The Parties may comment publicly, however, on the nature of the Consent Decree, and the merits of their respective positions, after it has been adopted by the Commission.

11. It is understood that BellSouth's agreement to this Consent Decree does not constitute an adjudication of any factual or legal issues or an admission by BellSouth of wrongdoing, violations or of any inconsistency between its position, on the one hand, and, on the other hand, (i) the Communications Act of 1934, as amended, and (ii) the rules and policies of the Commission. As a result, BellSouth shall not be precluded or estopped from litigating *de novo* any and all of the issues subject to this Consent Decree in any forum, except as provided herein.

12. The Parties agree that this Consent Decree and the Consent Decree Order may not be used in any fashion by either of the Parties to this Consent Decree in any legal proceeding except as set forth in this Consent Decree.

13. Adoption by the Commission of this Consent Decree shall conclude action in the proceeding commenced by the *Order to Show Cause*, 10 FCC Rcd 5637, and the Adjustments Report without a finding of wrongdoing, violations or liability on the part of BellSouth. The Parties agree that the effectiveness of this Consent Decree is expressly contingent upon issuance of the Consent Decree Order described herein, and compliance by BellSouth with the terms of this Consent Decree. If this Consent Decree is not signed by BellSouth and the Commission, or is otherwise rendered invalid by any court of competent jurisdiction, it shall become null and void and may not become part of the record in this proceeding.



14. If the Commission brings an action in any court of competent jurisdiction to enforce the terms of the Consent Decree order or the Consent Decree, BellSouth agrees that it will not contest the validity of either the Consent Decree Order or the Consent Decree, will waive any statutory right to contest the validity of the Consent Decree Order or this Consent Decree through a trial *de novo*, and will consent to a judgment incorporating the terms of this Consent Decree without change, addition or modification provided, however, that the Commission has complied with all of its obligations under the Consent Decree.

15. This agreement may be signed in counterparts.

## FEDERAL COMMUNICATIONS COMMISSION

By: William F. Cinton

Acting Secretary

Signed this 21<sup>st</sup> day of October, 1996

## BELLSOUTH TELECOMMUNICATIONS, INC.

By: M. J. [Signature]

Its Vice-Pres., Regulatory (Title)

Signed this 24<sup>th</sup> day of October, 1996